THE SECRETARY OF TRANSPORTATION

WASHINGTON, D.C. 20590

January 20, 2004

The Honorable Charles E. Grassley
Chairman, Committee on Finance
United States Senate
Washington, DC 20510-6200

Dear Mr. Chairman:

This is in response to your letter of November 17 requesting the assistance of the Department of Transportation in addressing the use of certain leasing arrangements in the transportation industry.

As you know, public transportation agencies have participated in a number of transactions in which their assets were transferred to private sector firms, which then claimed tax benefits through the depreciation of these assets. However, the Assistant Secretary of the Treasury for Tax Policy requested in a letter to me dated November 26, 2003, that, "Until otherwise advised...the Department of Transportation no longer permit these and similar transactions, in whole or in part." Consequently, the Federal Transit Administration (FTA) has suspended its review of proposed transactions until further notice. A copy of the letter is enclosed for your information.

FTA has been reviewing leveraged lease transactions since 1988, when foreign corporations first began to buy and lease back rail cars for depreciation benefits in their own countries. On April 26, 1990, FTA (then the Urban Mass Transit Administration) published its Cross-Border Leasing Guidelines in Circular 7020.1, providing a framework for public transit agencies to follow if they undertook these transactions, and explaining the basis for FTA's review.

FTA's review of these types of transactions has been limited to an analysis of their projected impact on the use of property purchased in large part with Federal funds. That review in no way constituted an endorsement of any particular transaction. FTA has never reviewed proposed lease arrangements for compliance with tax law or policy – that is the responsibility of the Department of the Treasury. In March 1999, the Internal Revenue Service issued Revenue Ruling 99-14, denying the tax benefits of a transaction type called a "Lease-in/Lease-out" or LILO. Since the publication of that revenue ruling, FTA has not received, reviewed, or concurred in any LILO transactions. Instead, the industry modified the transactions to change their form to "Sale-in/Lease-out" transactions, or SILOs. While the Treasury Department has ruled LILOs to be abusive tax shelters, the Department of Transportation is unaware of any ruling to date on SILOs. In the November 26 letter, however, we were notified that the Department of the Treasury and the Internal Revenue Service are "considering whether, and in what form, to issue published guidance" on SILO transactions.

The Department stands ready to assist your Committee in addressing this important public policy issue, and will, of course, provide all requested documents. Please feel free to contact me or Nicole Nason of my staff at (202) 366-4573, as we proceed in addressing the matter.

Sincerely yours,

Norman Y. Mineta

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON

ENCLOSURE

ASSISTANT SECRETARY

November 26, 2003

The Honorable Norman Y. Mineta
Secretary
U.S. Department of Transportation
400 Seventh Street, SW
Washington, DC 20590

Dear Mr. Secretary:

We understand that certain corporations are engaging in transactions with municipalities and other state and local governmental units that the corporations assert permit them to claim Federal income tax deductions with respect to Federally-funded public transportation capital assets. We also understand that many of these transactions have been permitted by the Federal Transit Administration (FTA). As a legal matter, the structures of the transactions raise substantial questions about whether the asserted tax benefits are allowable. As a policy matter, the cost of these transactions to the Federal Treasury is significantly higher than the benefits to the municipalities. These and similar transactions should no longer be permitted by the Department of Transportation.

Background and Description of a Typical SILO Transaction

Certain corporations are now engaging in transactions known as "sale-in/lease-out" or "SILO" transactions. These transactions involve arrangements that vary little in substance from prior "lease-in/lease-out" or "LILO" transactions that the IRS concluded should not be respected for federal income tax purposes. The IRS and the Treasury Department "listed" or designated LILOs as abusive tax avoidance transactions and the IRS is challenging the validity of LILOs on audit and will challenge LILOs in court.

SILOs employ the same fundamental contractual arrangements as LILOs, but typically involve a service contract arrangement. In addition, certain corporations have entered into similar arrangements involving qualified technological equipment. In the typical SILO transaction, a U.S. corporate taxpayer simultaneously enters into a leveraged lease of a municipality's existing asset, and leases the property back to the municipality. For example, a corporation enters into a 99-year lease (the "head lease") for a $100 million transportation asset (the "property"), which the corporation treats as a purchase for federal tax purposes because the head lease term is in excess of the property's useful life. The corporation simultaneously leases the property back (the "leaseback") to the municipality for 25 years. The leaseback term is less than 80 percent of the property's remaining useful life. At the conclusion of the 25-year leaseback term, the municipality has a buyout option, discussed below.

The corporation finances the $100 million purported purchase price with a combination of an $86 million nonrecourse loan and $14 million of equity. The municipality simultaneously deposits $96 million of the $100 million it receives into accounts pledged for the benefit of the corporation and the lender. The $96 million amount defeases the municipality's obligations under the leaseback and the buyout option. In other words, simultaneously with the head lease and leaseback transaction, the municipality pledges substantially all of the funds necessary to pay the municipality's rent due under the leaseback and to allow the municipality to exercise its buyout option at the end of the leaseback term. Thus, without any further cost or expenditure, the municipality may use the property for the entire leaseback term and reacquire all rights to the property at the end of that term. The $96 million amount deposited by the municipality represents all of the corporation's nonrecourse borrowing and the corporation's $14 million equity investment less a $4 million amount that is in essence an accommodation fee received by the municipality for engaging in the transaction.

Upon expiration of the leaseback term, the municipality has an option to purchase the property for a predetermined price. Typically, one of the defeasance accounts established by the municipality will hold securities that mature on the buyout option date in the amount needed to fund the buyout price. If the municipality does not exercise the buyout option, the corporation has two alternatives. The corporation may take possession of the property. Alternatively, the corporation may require the municipality to locate a third party to enter into a service contract. If the municipality cannot locate a third party, the municipality will be in default unless it enters into the service contract. The practical effect of all of these arrangements for the property's disposition at the end of the leaseback term is that the municipality will exercise the defeased buyout option.

The corporation's position is that, for tax purposes, it owns the property. The corporation claims depreciation deductions equal to the property's $100 million value. The corporation also claims interest deductions on the $86 million loan, which substantially offset the rental income that the corporation receives under the leaseback. The present value of the corporation's $35 million tax savings from depreciation deductions (representing its 35-percent tax rate multiplied by the $100 million depreciable basis of the property) exceeds the $4 million payment made to the municipality.

The transaction results in no change in the municipality's use or operation of, or beneficial interest in, the property. Given the defeasance accounts and the totality of the arrangements, there is no shifting of the benefits and burdens of ownership. Further, the transaction does not provide the municipality with any available funds other than the $4 million fee for participating in the transaction. Consequently, the transaction has no apparent purpose other than shifting "tax ownership" of the property away from a tax-exempt entity (the municipality) to a taxable entity (the corporation), which then claims depreciation deductions of $100 million.

SILOs Have Questionable Legal Support

Sale-leaseback transactions are a time-honored method of raising capital to finance or refinance acquisition or construction. Generally, the substance of a transaction, not its form, governs its tax treatment. In Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978), the Supreme Court applied the doctrine of substance over form in determining that a transaction was, in substance, a sale-leaseback, rather than a financing.

Considering the totality of the transaction, SILOs are fundamentally different than the sale-leaseback transaction respected by the Court in Frank Lyon. Unlike the situation in Frank Lyon, SILOs do not provide available funds for financing or refinancing the construction or purchase of assets. Other than the accommodation fee paid to the municipality, none of the cash flows involved in a SILO are available for use by the municipality. In contrast, substantially all of the proceeds in the sale-leaseback at issue in Frank Lyon were used for construction of the lessee's new headquarters. In a SILO, the corporation (the purported owner of the leased property) is not at risk for its equity investment. The defeasance typically renders default risks remote and, even in the event of default, will not leave the corporation at risk for either repaying the loan balance or forfeiting the portion of its equity investment held in a defeasance account. On the other hand, the taxpayer in Frank Lyon bore the risk of the lessee's nonpayment of the rent, which could have forced the taxpayer to default on its recourse debt with respect to the leased property. In our view, the substance of the SILO arrangement thus does not represent a valid sale-leaseback.

Generally, a sale-leaseback will not be respected unless the "lessor retains significant and genuine attributes" of a traditional owner, including "the benefits and burdens of ownership." Coleman v. Commissioner, 16 F.3d 821, 826 (7th Cir. 1994) (citing Frank Lyon, 435 U.S. at 582-584). Unlike the corporation in a SILO, the taxpayer in Frank Lyon was at risk for its equity investment, which the Court viewed as a key factor supporting the form of a transaction as a transfer of the benefits and burdens of ownership in the sale-leaseback. In the typical SILO transaction, most of the corporation's equity investment is deposited in a defeasance account designed to ensure that the corporation will recoup those funds (plus an investment return on the funds) through either the municipality's exercise of the buyout option or the payments under the service contract. The buyout option and service contract arrangements, particularly when combined with defeasance and credit support, protect the corporation from loss and limit the potential for any profit.

The nature of the property makes it likely that the municipality will exercise its buyout option. For example, a municipal transportation authority is unlikely to permit property, such as a subway line, to be acquired by the corporation or any other private party. Moreover, it is unlikely that the municipality will allow the property to be operated by a private corporation because of practical considerations, such as immunity from liability and employment agreements, and other political constraints.

Based on these factors, among others, and notwithstanding the form of the transaction, the substance of the SILO's overall structure and cash flows represent a monetization of the tax benefits derived from the depreciation deductions claimed by the corporation on the municipality's property rather than productive leasing or financing activity. The fee paid to the municipality represents a fraction of the tax benefits realized by the corporation engaging in the transaction, which does not, in substance, own the municipal property.

In light of these concerns, the Treasury Department and the IRS are evaluating the SILO transaction and considering whether, and in what form, to issue published guidance. We will advise you of any developments in this regard. Until otherwise advised, we ask that the Department of Transportation no longer permit these and similar transactions, in whole or in part.

Proposed Legislation

As you are aware, legislation has recently been proposed in Congress that would specifically address SILOs. This proposal would provide certainty that the tax benefits from these transactions are not allowable and would end corporations' use of SILO transactions involving transportation infrastructure.

We appreciate your attention to this matter. If you have any questions or need anything further, please do not hesitate to contact us.

Sincerely,

Pam Olson

Pamela F. Olson
Assistant Secretary (Tax Policy)